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DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 01-0094
Indiana Corporate Income Tax
For Tax Years 1995 through 1998

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superceded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUE

I. Adjusted Gross Income Tax—Royalty Fee Deduction

Authority: *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 63 S.Ct. 1132 (1943); *General Finance Corp. v. Skinner, 426 N.E.2d 77 (Ind. Ct. App. 1981)*; *Park 100 Dev. Co. v. Indiana Dep't of State Revenue*, 429 N.E.2d 220 (Ind. 1981); *Extra Energy Coal Co. v. Diamond Energy & Resources, Inc.*, 467 N.E.2d 439 (Ind. Ct. App. 1984); *Smith v. McCleod Distrib., Inc.*, 744 N.E.2d 459 (Ind. Ct. App. 2000); *Sweetland v. Franchise Tax Board*, 192 Cal. App. 2d 316 (Cal. App. 1st Dist. 1961)
IC 6-3-2-2(m)

Taxpayer protests the Audit Division's determination that taxpayer's deductions for royalty fees should be disallowed.

II. Gross Income Tax—Statute of Limitations

Authority: IC 6-8.1-5-2

Taxpayer protests all of the adjustments made by the auditor for the tax periods ending December 31, 1995 and December 31, 1996 on the grounds that the statute of limitations has expired.

III. Tax Administration—Abatement of Penalty

Authority: IC 6-8.1-10-2.1(d)
45 IAC 15-11-2(c)

Taxpayer protests imposition of a ten percent (10%) negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana corporation that operates under the umbrella of its parent corporation (hereinafter, "Parent"). Parent, located in Michigan, is a large retailer of building materials, and an operator of door assembly, truss plants, and lumber and building supply distribution centers. Although Parent is located in Michigan, all corporate functions of purchasing, accounting, payroll, trade payables, and property tax payments are performed by a subsidiary corporation headquartered in Ohio (hereinafter, the "Ohio Subsidiary"). The Ohio Subsidiary holds the rights to certain trademarks and corporate logos used by other subsidiaries of Parent. The Ohio Subsidiary charges to its subsidiaries a royalty fee for the use of its trademarks and corporate logos.

Taxpayer, an Indiana corporation and subsidiary of Parent, holds a ninety-nine percent (99%) interest in a partnership formed in 1993 (hereinafter, the "Partnership"). The Partnership was formed between taxpayer and a Kentucky corporation that was also a subsidiary of Parent, for the purpose of holding all of the Indiana assets and the Indiana retail stores. Prior to 1993, taxpayer operated the Indiana retail stores. Taxpayer and the Partnership were found to enjoy a unitary relationship. Taxpayer reports no retail store assets on its balance sheet, and performs no function other than to hold the Partnership investment. Taxpayer reports as its only income the distributive share of the profits and losses of the Partnership.

The Department of Revenue conducted an audit for the tax years in question, and determined, *inter alia*, that taxpayer erred in deducting the royalty fee expenses that it paid to Parent. Additional facts will be provided as necessary.

I. <u>Adjusted Gross Income Tax</u>—Royalty Fee Deduction

DISCUSSION

Pursuant to a royalty agreement (hereinafter, the "Agreement"), taxpayer agreed to pay the Ohio Subsidiary a one percent (1%) royalty fee for the use of various corporate logos. Taxpayer took deductions on its tax returns for the royalty fee expenses. Pursuant to the audit, the auditor disallowed the deduction for royalty expenses. The deduction was disallowed because, according to the auditor, the royalty expenses were charged in a non-uniform manner for the purpose of, *inter alia*, transferring income outside of Indiana. The auditor found that the royalty expenses were charged only to taxpayer, a Kentucky subsidiary, and a Pennsylvania subsidiary, and not to the subsidiaries located in Illinois, Michigan, North Carolina, South Carolina, Virginia, Wisconsin, and Ohio.

Taxpayer argues that whether or not the expenses were charged in a uniform manner to all of the operating subsidiaries is of no significance. According to taxpayer, the deduction is still a valid and appropriate deduction for those divisions that did pay the expenses to the Ohio Subsidiary.

Indiana law gives the Department the authority to apportion or allocate income derived from Indiana sources among commonly owned organizations in order to fairly reflect said Indiana income. Specifically, IC 6-3-2-2(m) states that:

> "[i]n the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

The Department determined that the Ohio Subsidiary was the subsidiary designated by Parent to hold all trademarks and corporate logos. The auditor determined that the royalty fees charged for the use of the trademarks and logos were not paid according to each subsidiary's respective usage. Instead, royalty fee amounts were paid to the Ohio Subsidiary by only a small number of subsidiaries. From this information, the auditor determined that individual usage of the trademarks and logos played no part in whether or not the subsidiary was obligated to pay royalty fees Therefore, in an effort to ensure that income generated in Indiana was not distorted and unfairly attributed to another state, the auditor disallowed taxpayer's deduction for royalty fees. It appears that the Audit Division's position is that taxpayer is not operating as a separate and distinct business entity from the Ohio Subsidiary. Instead, taxpayer is a merely an instrumentality of the Ohio Subsidiary.

"[The fiction of a corporate entity] may be disregarded where one corporation is so organized and controlled and its affairs so conducted that it is a mere instrumentality or adjunct of another corporation." *Extra Energy Coal Co. v. Diamond Energy & Resources, Inc.*, 467 N.E.2d 439, 441 (Ind. Ct. App. 1984). "Indiana courts [will] refuse to recognize corporations as separate entities where the facts establish several corporations are acting as the same entity." *General Finance Corp. v. Skinner*, 426 N.E.2d 77, 84 (Ind. Ct. App. 1981). In assessing whether a organization's corporate existence may be ignored, the following factors may be considered: "(1) undercapitalization; (2) absence of corporate records; (3) fraudulent representation by corporation shareholders or directors; (4) use of the corporation to promote fraud, injustice or illegal activities; (5) payment by the corporation of individual obligations; (6) commingling of assets and affairs; (7) failure to observe required corporate formalities; or (8) other shareholder acts or conduct ignoring, controlling, or manipulating the corporate form." *Smith v. McCleod Distrib., Inc.*, 744 N.E.2d 459, 463 (Ind. Ct. App. 2000). That same court noted that "other jurisdictions have disregarded the separateness of affiliated corporations when the corporations are not operated as separate entities but are manipulated or controlled as one enterprise through their interrelationship to cause illegality, fraud, or injustice or to permit one economic entity to escape liability arising out of an operation conducted by one corporation for the benefit of the whole enterprise." *Id*.

It is well-settled that corporations are free to adopt the corporate form and to engage in activities they deem appropriate. The Supreme Court has stated that the doctrine of corporate entity serves a useful purpose and that "so long as [the] purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438-439, 63 S.Ct. 1132, 1134 (1943). However, the Court continued, stating that, "in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." *Id*. at 439. The state courts have been consistent in applying this "business purpose" doctrine, holding that tax avoidance in and of itself is not a valid "business purpose." *See Park 100 Dev. Co. v. Indiana Dep't of State Revenue*, 429 N.E.2d 220 (Ind. 1981); *Sweetland v. Franchise Tax Board*, 192 Cal. App. 2d 316 (Cal. App. 1st Dist. 1961).

Pursuant to the audit, the auditor determined that in 1993 taxpayer and a Kentucky corporation formed a partnership for the purpose of holding all of the Indiana assets and the Indiana retail stores. Taxpayer's contribution to the Partnership consisted of a substantial contribution of Indiana store assets. Prior to 1993, taxpayer operated the Indiana retail stores. Taxpayer and the Partnership were found to enjoy a unitary relationship.

The auditor further determined that in addition to holding the rights to trademarks and corporate logos, the Ohio Subsidiary controls the operations of all of the Indiana retail stores. All corporate functions and day-to-day operations, as well as all asset and inventory purchases, accounting, payroll, invoicing, payables, and property tax payments are performed at the Ohio Subsidiary's headquarters. Neither the Partnership nor taxpayer maintain an office location or management employees separate from the Ohio Subsidiary. The Ohio Subsidiary and taxpayer share corporate officers.

It appears that the Audit Division's position is that taxpayer is not operating as a separate and distinct business entity from the Ohio Subsidiary. Instead, taxpayer is merely an instrumentality of the Ohio Subsidiary. However, the documentation within the file does not support such a finding by audit. Notwithstanding the auditor's finding that the Ohio Subsidiary controls the operations of the Indiana retail stores, the auditor also found that the Ohio Subsidiary charges various fees to the retail stores. For example, the Ohio Subsidiary charges an administrative fee to each store based on sales volume; allocates a charge for rent to each store; charges a service fee for inventory items purchased by the stores from the Ohio Subsidiary; and charges a one percent (1%) royalty fee for use of the trademarks and logos.

Taken in total, the evidence on file supports a determination that taxpayer and the Partnership are operating as a viable entity with economic and business substance that is separate and distinct from that of the Ohio Subsidiary. The auditor found taxpayer's and the Partnership's activities to be a unitary business under established standards. The auditor further found that taxpayer had high rate gross income equal to ninety-nine percent (99%) of the Partnership's taxable income.

FINDING

The taxpayer's protest is sustained.

II. Gross Income Tax—Statute of Limitations

DISCUSSION

Taxpayer protests all of the adjustments made by the auditor for the tax periods ending December 31, 1995 and December 31, 1996 on the grounds that the statute of limitations has expired. According to taxpayer's records, the statute of limitations expired on August 30, 2000.

The time limitation on issuance of a proposed assessment is governed by IC 6-8.1-5-2 which provides in pertinent part:

> Except as otherwise provided in this section, the department may not issue a proposed assessment under section 1 of this chapter more than three (3) years after the latest of the date the return is filed, or any of the following:
>
> (1) the due date of the return; or
>
> (2) in the case of a return filed for the state gross retail or use tax . . . the end of the calendar year which contains the taxable period for which the return is filed.
>
> . . .
>
> (e) If a person files a fraudulent, unsigned, or substantially blank return, or if a person does not file a return, there is no time limit within which the department must issue its proposed assessment.

IC 6-8.1-5-2(a), (e).

The evidence of file establishes that on April 14, 2000, taxpayer's Chief Financial Officer executed two Forms AD-10, Agreement to Extension of Time, which stated respectively that any tax due by taxpayer for the tax year 1995 and for the tax year 1996 could be assessed at any time on or before August 30, 2000. However, on July 28, 2000, taxpayer's Chief Financial Officer executed two additional Forms AD-10 extending the time limit of assessment for tax years 1995 and 1996 until October, 15, 2000. Finally, on September 8, 2000, taxpayer's Chief Financial Officer executed one Form AD-10 extending the time limit of assessment for tax year 1996 until January 1, 2001.

The auditor completed her audit on September 9, 2000. The notice for proposed assessments was issued October 18, 2000. The assessment was for the IT-20 tax return for the period ending December 31, 1998. In fact, the only assessment that the Department issued against taxpayer was for the tax year ending December 31, 1998. No error occurred here.

FINDING

Taxpayer's protest is respectfully denied.

III. Tax Administration—Abatement of Penalty

DISCUSSION

The Audit division determined that a ten percent (10%) negligence penalty should be imposed upon taxpayer. Taxpayer disagrees with the imposition of said penalty.

Under IC 6-8.1-10-2.1(d), the Department is empowered to waive the ten-percent negligence penalty if the taxpayer can establish that its failure to pay the tax deficiency was due to reasonable cause and not due to willful neglect. Under 45 IAC 15-11-2(c), in order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying our failing to carry out a duty giving rise to the penalty imposed. Ignorance of the listed tax laws, rules, and/or regulations is treated as negligence. Factors which may be considered to determine reasonable cause include the nature of the tax involved, judicial precedents set by Indiana courts, judicial precedents established by jurisdictions outside Indiana, published Department instructions, information bulletins, letters of findings, rulings, and letters of advice. 45 IAC 15-11-2(c).

The Audit Division imposed the negligence penalty because taxpayer failed to accurately report its taxable income. Taxpayer points to no precedents, instructions, bulletins, statutes, or regulations which justify its failure to pay the full amount of its state tax. Even assuming that taxpayer's failure to pay the appropriate amount of tax was entirely attributable to an innocent mistake, taxpayer still is unable to establish a "reasonable cause" for that error.

FINDING

Taxpayer's protest is respectfully denied.

HLS/JM/MR-022803